

STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS (Continued)
FISCAL YEAR ENDED SEPTEMBER 30, 2000

NOTE 28 – CONTINGENCIES AND COMMITMENTS

A. Primary Government

Litigation

The State accrues liabilities related to significant legal proceedings if a loss is probable and reasonably estimable. In the event that a significant, probable, and reasonably estimable loss is not settled prior to the preparation of these statements, the obligation is recorded as a general long-term liability or fund liability, depending on the fund type (see Note #14).

The State is a party to various legal proceedings seeking damages, injunctive, or other relief. In addition to routine litigation, certain of these proceedings could, if unfavorably resolved from the point of view of the State, substantially affect State programs or finances. These lawsuits involve programs generally in the areas of corrections, tax collection, commerce and budgetary reductions to school districts and governmental units, and court funding. Relief sought includes damages in tort cases generally, alleviation of prison overcrowding, improvement of prison medical and mental health care, and refund claims under State taxes. The State is also a party to various legal proceedings which, if resolved in the State's favor, would result in contingency gains to the State's General Fund balance, but without material effect upon fund balance. The ultimate dispositions and consequences of all of these proceedings are not presently determinable, but such ultimate dispositions and consequences of any single proceeding or all legal proceedings collectively should not themselves, except as listed below, in the opinion of the Attorney General of the State and the Department of Management and Budget, have a material adverse effect on the State's financial position.

10th Judicial Circuit et al v State of Michigan et al: On August 22, 1994, the Ingham Circuit and Probate Courts, together with the 55th District Court, filed suits in the Court of Claims and Ingham County Circuit Court against the State of Michigan and Ingham County entitled, 30th Judicial Circuit et al v Governor et al for declaratory and injunctive relief, and for damages, due to the alleged failure of the State Court Administrative Office to properly calculate Ingham County's reimbursement under MCL 600.9947; MSA 27A.9947, the court funding statute. The 30th Judicial Circuit et al v Governor et al case has been dismissed by stipulation of the parties because the plaintiffs are raising

the same claims as members of a class action captioned as 10th Judicial Circuit et al v State of Michigan et al (Saginaw Circuit Court No. 94-2936-AA-1/Court of Claims No. 94-15534-CM). Plaintiffs assert that the amount in controversy exceeds \$5 million. The case is currently pending final class certification.

Durant v State of Michigan (Durant II): In a decision rendered October 19, 1999, the Court of Appeals held that the State School Aid Act complied with the State's obligations under Article 9, § 29 of the Michigan Constitution to fund the State-mandated portions of the special education, special education transportation, and school lunch programs at the levels required by the Headlee Amendment.

The Court of Appeals further held that certain sections of the State School Aid Act violated Article 9, § 11 of the Michigan Constitution. Article 9, § 11 of the Michigan Constitution provides, in part, that beginning in the 1995-96 state fiscal year, and each fiscal year thereafter, the State shall guarantee that the total state and local per pupil revenue for school operating purposes for each local school district shall not be less than the 1994-95 total state and local per pupil revenues for school operating purposes. The Court held that under Article 9, § 11, the Legislature must appropriate the State portion of the per pupil revenue for school operating purposes to local school districts as unrestricted school aid. Thus, the Court held that to the extent the Legislature appropriated restricted funds to pay for special education and special education transportation from funds that were guaranteed to local school districts as unrestricted aid, the amendments to the State School Aid Act violated Article 9, § 11.

The Court of Appeals denied plaintiffs' request for mandamus, injunctive relief, and monetary damages and, as described above, granted declaratory relief only. The Court also held that plaintiffs may petition for costs and reasonable attorney fees as allowed by Article 9, § 32 of the Michigan Constitution. Under the court rules, the parties had until November 9, 1999 to appeal the decision to the Supreme Court or to move for

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rehearing in the Court of Appeals. Neither party appealed the decision nor moved for rehearing. Plaintiffs' petition for costs and attorney fees was granted by the Court of Appeals on January 14, 2000 in the amount of approximately \$.4 million. On February 4, 2000 the State filed an application for leave to appeal and motion for peremptory reversal of the January 14, 2000 Court of Appeals order in the Supreme Court. On June 20, 2000, the Supreme Court denied the State's appeal and on August 22, 2000, denied the State's motion for reconsideration. Therefore, in October 2000, payments were made to plaintiff school districts reflecting their share of the \$400,000 in attorney fees. This case was dismissed on November 27, 2000.

Durant et al v State of Michigan et al (DURANT III): On November 15, 2000, more than 365 Michigan school districts and individuals filed two suits in the Michigan Court of Appeals. The first suit, Durant et al v State et al, asserts that the current State School Aid Act, P.A. 297 of 2000, violates Michigan Constitution, Article 9, §§ 25-34 (the "Headlee Amendment"), because it allegedly transfers per pupil revenue guaranteed to school districts under Const 1963, Article 9, § 11, for unrestricted school operating purposes, in order to satisfy the State's independent funding obligation to those school districts under Article 9, § 29. The plaintiffs in Durant III are seeking a monetary remedy, including approximately \$1.7 billion for the 1999-2000 through 2002-03 school years for the State's alleged underfunding of special education programs and services, including special education transportation services. The Durant III plaintiffs are also requesting a declaratory judgment that the State, through P.A. 297 of 2000, is violating Article 9, § 11, and Article 9, § 29. The Durant III plaintiffs further seek orders declaring that the State has failed, through P.A. 297 of 2000, to meet its constitutional duty to fund services and activities provided by the plaintiff school districts during school years 1999-2000 through 2002-03 in the same proportion by which they were funded when the Headlee Amendment became effective, and that the State has reduced the State-financed proportion of necessary costs incurred by the plaintiff school districts for special education services for the 1999-2000 through 2002-03 school years below that provided by the State when the Headlee Amendment became effective. The Durant III plaintiffs also seek an injunction permanently enjoining the State from making any future reductions below the levels of funding provided when the Headlee Amendment became effective to pay for the cost of the activities and services required of them by State law. They also seek attorneys fees and costs of litigation.

The second suit, Adair et al v State et al ("Adair"), asserts that the State has, by operation of law, increased the level of various specified activities and services beyond that which was required by State law as of December 23, 1978 and, after December 23, 1978, added various specified new activities or services by State law, including mandatory increases in student instruction time, without providing funding for these new activities and services, all in violation of the Headlee Amendment. The Adair plaintiffs are seeking an unspecified money judgment equal to the reduction in the State financed proportion of necessary costs incurred by the plaintiff school districts for each school year from 1997-98 through the date of any judgment and for attorneys fees and litigation costs. The Adair plaintiffs also seek a declaratory judgment that the State has failed to meet its funding responsibility under the Headlee Amendment to provide the plaintiff school districts with revenues sufficient to pay for the necessary increased costs for activities and services first required by State law after December 23, 1978, and to pay for increases in the level of required activities and services beyond that which was required by State law as of December 23, 1978.

Loss Contingencies

The State receives significant financial assistance from the federal government in the form of grants and entitlements. The receipt of federal grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal regulations. Substantially all federal grants are subject to either federal single audits or financial and compliance audits by grantor agencies. Questioned costs as a result of these audits may become disallowances after the appropriate review of federal agencies. Material disallowances are recognized as either fund liabilities or liabilities of the General Long-Term Obligations Account Group when the loss becomes probable and reasonably estimable. As of September 30, 2000, the State estimates that additional disallowances of recognized revenue will not be material to the general purpose financial statements.

The Department of Community Health (DCH) administers the School Based Outreach Services Program, which provides certain health services to school-aged children. DCH receives federal reimbursements from the U.S. Department of Health and Human Services for the direct services provided and for related administrative costs of this program. On August 31, 2000, the U.S. Health Care Financing Administration (HCFA) disallowed \$103.6 million in federal financial participation for the costs related to Medicaid administrative activities claimed by DCH under their Medicaid School Based Outreach Services program. The disallowed amount represents claims for Medicaid administrative activities for the quarters ended September 1998, September 1999, and December 1999. The State has formally appealed the disallowance and expects it to be reversed.

Federal sanctions that may result in a loss to the State include \$40.6 million for the Food Stamp program and \$38.6 million for the Child Support Enforcement System.

The Wayne County Friend of the Court notified the State that they may have misdirected payments to FIA. Any potential reimbursement for these payments cannot be reasonably estimated.

Gain Contingencies

Certain contingent receivables related to the Family Independence Agency are not recorded as assets in these statements. Amounts recoverable from Family Independence Agency grant recipients for grant overpayments or from responsible third parties are recorded as receivables only if the amount is reasonably measurable, expected to be received within 12 months, and not contingent upon future grants or the completion of major collection efforts by the State. If recoveries are accrued and the program involves federal participation, a liability for the federal share of the recovery is also accrued. The unrecorded amount of potential recoveries which are ultimately collectible cannot be reasonably determined.

In November 1998, the Attorney General joined 45 other states and five territories in a settlement with the nation's largest tobacco manufacturers. The settlement includes base payments to states totaling \$220.6 billion over the next 25 years, and continues in perpetuity. Michigan's share of the settlement is expected to be \$8.5 billion over the next 25 years, and \$348.3 million thereafter, adjusted for inflation and other factors. The State also received \$2.2 million, representing costs incurred to litigate the case. While Michigan's share of the base payments will not change over time, the amount of the annual payment is subject to a number of modifications

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including adjustments for inflation and usage volumes. Some of the adjustments may result in increases in the payments (inflation, for example), while other adjustments will likely cause decreases in the payments (volume adjustments, for example). The net effect of these adjustments on future payments is unclear, therefore only receivables and deferred revenues which can be reasonably estimated have been recorded for the future payments.

Construction Projects

As of September 30, 2000, several construction projects were in progress, with several others in the planning stages. A more detailed discussion of construction commitments is included in the construction in progress disclosures (Note #10).

The Department of Transportation has entered into construction contracts that will be paid with transportation related funds. As of September 30, 2000, the balances remaining in these contracts equaled \$500.2 million.

Contingent Liability for Local School District Bonds

Public Act 108 of 1961, as amended, resulted in a contingent liability for the bonds of any school district which are "qualified" by the Superintendent of Public Instruction. Every qualified school district is required to borrow and the State is required to lend to it any amount necessary for the school district to avoid a default on its qualified bonds. In the event that funds are not available in the School Bond Loan Fund in adequate amounts to make such a loan, the State is required to make such loans from the General Fund. As of December 31, 2000, the principal amount of qualified bonds outstanding was \$9.8 billion. Total debt service requirements on these bonds including interest will approximate \$858.9 million in 2001. The amount of loans by the State (related to local school district bonds qualified under this program), outstanding to local school districts as of September 30, 2000, is \$346.6 million. Interest due on these loans as of September 30, 2000, is \$59.4 million.

Michigan Underground Storage Tank Financial Assurance Fund (MUSTFA) Projects

The MUSTFA Fund, a special revenue fund, receives revenues dedicated to reimbursing owners/operators of underground storage tanks (UST) for costs incurred related to conducting corrective actions at sites where a release has occurred from an UST. The MUSTFA reimbursement fund was declared insolvent and received no additional claims after June 29, 1995. The revenue is still collected to pay off two main obligations of the MUSTFA Fund: the long-term liability for incurred claims recorded in the General Long-Term Obligations Account Group, which is discussed in Note 14, and the debt and debt service charges associated with the financial borrowing mechanisms utilized to expedite reimbursement to eligible owners/operators.

B. Discretely Presented Component Units

Student Loan Guarantees

The Michigan Higher Education Assistance Authority (MHEAA) is contingently liable for loans made to students by financial institutions that qualify for guaranty. The State of Michigan, other than MHEAA, is not liable for these loans. MHEAA's default ratio is currently below 5% for the fiscal year ended September 30, 2000. As a result, the federal government's reinsurance rate for defaults for the fiscal year ended September 30, 2000, is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1, 1993 to September 30, 1998. In the event of future adverse default experience, MHEAA could be liable for up to 25% of defaulted loans. Management does not expect that all guaranteed loans could default in one year. For loans made on or after October 1, 1999 the reinsurance rate will be 98%. In the event of future adverse default experience, MHEAA could be liable for up to 25% of such defaulted loans. Accordingly, MHEAA's expected maximum contingent liability is less than 25% of outstanding guaranteed loans; however, the maximum contingent liability at September 30, 2000, is \$632.6 million.

MHEAA entered into commitment agreements with all lenders that provide, among other things, that MHEAA will maintain cash and marketable securities. MHEAA was in compliance with this requirement as of September 30, 2000, at an amount sufficient to guarantee loans in accordance with the Higher Education Act of 1965, as amended.